(1)

Supreme Court, U.S.
FILED

001345 FEB 16 2001

OFFICE OF THE CLERK

No. _____

IN THE
Supreme Court of the United States

JOBST W.F. BLACHY, et al.,
Cross-petitioners,

v.

ROSEMARY C. BUTCHER, et al.,
Respondents.

On Petition For Writ of Certiorari
to The United States Court of Appeals
For The Sixth Circuit

CONDITIONAL CROSS-PETITION FOR WRIT OF CERTIORARI

JAMES A. SMITH*
JEFFREY G. RAPHELSON
BODMAN, LONGLEY & DAHLING LLP
34TH FLOOR, 100 RENAISSANCE CENTER
DETROIT, MI 48243
(313) 259-7777
**Counsel of Record*

February 15, 2001

19 pp

QUESTION PRESENTED

May the lien of the Internal Revenue Service for taxes unpaid by Alexander and Rosemary Butcher be satisfied by sale of the property owned by cross-petitioners and held in constructive trust by the Butchers, when the Butchers have been judicially determined to own only bare legal title and no beneficial interest?

PARTIES

This is a conditional cross-petition. The opening petition is docketed as No. 00-1155. The cross petitioners are all respondents to the opening petition other than the United States:

Jobst W.F. Blachy; Lynn A. Blachy; Davida Gale; Peter E. Boss; Jeanette A. Boss; Kenneth W. Gitlin; Roslyn E. Gitlin; Joseph H. Jones; Barbara Ann Jones; T.F.C. Agency, Incorporated, a Michigan Corporation; George F. Malley; Barbara C. Malley; Richard A. Monash; Carol Monash; Charlotte R. Monash; E. Jerome McCarthy; Gunther S. Meisse; Jeanne R. Meisse; Irving Shanbom; Patricia Shanbom; Ronald W. Mitchell; Patricia W. Mitchell; Anthony J. D'Errico; Ann T. D'Errico; Northwestern Savings and Loan Association; Lawyers Title Insurance Corporation; Thomas G. Allshouse; Sheryle K. Allshouse; and First Nationwide Bank.

Respondent Lawyers Title Insurance Corporation is a principal subsidiary of a publicly owned corporation, LandAmerica Financial Group, Inc. No other respondent corporation has either a publicly owned parent or nonwholly owned subsidiary company.

Respondents to this cross-petition are Petitioners in the Opening Petition and the United States. The Petitioners in the Opening Petition are:

Robert E. Butcher and Rosemary C. Butcher, co-personal representatives of the estate of Alexander M. Butcher, deceased; Rosemary C. Butcher, an individual; Little Traverse Development Company, a Michigan Corporation, and H.C. Development Company, a Michigan Corporation. The corporate entities, Little Traverse Development Company and H.C. Development Company have no parent companies or nonwholly owned subsidiaries.

TABLE OF CONTENTS

QUESTION PRESENTED i
PARTIES ii
TABLE OF CONTENTS iii
INDEX OF AUTHORITIES iv
OPINIONS BELOW 1
JURISDICTION 1
STATUTES INVOLVED 1
Bankruptcy Code — Property of the Estate 1
Internal Revenue Code — Property of Delinquent Taxpayer 2
STATEMENT OF THE CASE 2
REASONS FOR GRANTING WRIT 2
A. Under Michigan Law, A Constructive Trust Arose Upon The Wrongful Conduct of The Butchers, Immediately Stripping The Butchers' Equitable Interest In The Property. 3
B. The Holding Of The Court of Appeals *In re Omegas*, That A Constructive Trust Does Not Arise Until Judicial Declaration, Is Contradicted By The Legislative History Of § 541(d) Of The Bankruptcy Code And Has Been Rejected As Wrongly Decided By The Majority Of Federal Courts To Consider It. .. 8
1. *In Re Omegas* Conflicts With The Legislative History of § 541(d) Of The Bankruptcy Code. 9
2. A Number Of Federal Courts Have Rejected *Omegas* As Wrongly Decided. 10
C. The Equities In This Case Favor The Condominium Owners, Not The IRS. 13
CONCLUSION 15

INDEX OF AUTHORITIES

Cases

Aquilino v. *United States*, 306 U.S. 509, 512, 80 S. Ct. 1277 (1960) 4, 7

Clark v. *Wetherill (In re Leitner)*, 236 B.R. 420, 423 (Bankr. D. Kan. 1999) 12

Dennis v. *United States*, 372 F.Supp. 563, 568 n.1 (E.D. Va. 1974) 8

Fidelity & Deposit Co. v. *Stordahl*, 353 Mich. 354, 91 N.W.2d 533 (1958) 5

FTC v. *Crittenden*, 823 F. Supp. 699 (C.D. Cal. 1993), *aff'd*, 19 F. 3d 26 (9th Cir. 1994) 7

In re Omegas Group, 16 F.3d 1443 (6th Cir. 1994) 8, 9

In re Reider, 177 B.R. 412 (Bankr. D. Me. 1994) ... 12

Kastle v. Clemons, 330 Mich. 28, 46 N.W. 2d 450 (1951) 14

McTevia v. *Adamo* (In re Atlantic Mortgage Corp.), 69 B.R. 321, 330 (Bankr. E.D. Mich. 1987) 6

Mullins v. *Burtch (In re Paul J. Paradise & Associates)*, 249 B.R. 360 (D. Del. 2000) 10

Nichols v. *Martin*, 277 Mich. 305, 269 N.W. 183 (1936) 4

Old Republic Nat'l Title Ins. Co. v. *Tyler (In re Dameron)*, 206 B.R. 394 (Bankr. E.D. Va. 1997), *aff'd*, 155 F.3d 718 (4th Cir. 1998) 11

Reliance Ins. Co. v. *Brown*, 40 B.R. 214 (W.D. Mo. 1984) 7

Schwarz v. *United States*, 191 F.2d 618 (4th Cir. 1951) 8

Skilled Nursing Professional Services v. *Sacred Heart Hosp. (In re Sacred Heart Hosp.)*, 175 B.R. 543 (Bankr. E.D. Pa. 1994) 11

Soo Sand & Gravel Co. v. *M. Sullivan Dredging Co.*, 259 Mich. 489; 244 N.W. 138, 140 (1932) .. 5, 6

Stephenson v. *Golden*, 279 Mich. 710, 276 N.W. 849 (1937) 4

TMG II v. *United States*, 778 F. Supp. 37 (D.D.C. 1991), *aff'd in part and rev'd in part*, 1 F.3d 36 (D.C. Cir. 1993)..... 7

United States v. *Dishman Independent Oil, Inc.*, 46 F.3d 523, 526 (6th Cir. 1995)..... 6

United States v. *Fontana*, 528 F. Supp. 137 (S.D.N.Y. 1981) 8

United States v. *Rogers*, 461 U.S. 677, 103 S. Ct. 2132 (1983) 14

Statutes

11 U.S.C. § 541(d) 8

26 U.S.C. § 6321. 9

Legislative History

H.R.Rep. No. 595, 95th Cong., 1st Sess., at 368 (1977); S.Rep. No. 989, 95th Cong., 2d Sess., at 82 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5868, 6324 10

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Sixth Circuit is reported at 22 F.3d 896 (6th Cir. 2000). It is appended to the opening petition at App. 1a. The Opinion of the District Court for the Western District of Michigan is reported at 35 F. Supp. 2d 554 (W.D. Mich. 1999). It is appended to the opening petition at App. 43a.

JURISDICTION

The Court of Appeals' Opinion was issued July 21, 2000. The Court of Appeals denied petitions for rehearing and suggestions of rehearing *en banc* filed by petitioners and cross-petitioners. This conditional cross-petition is filed within thirty days following the docketing of the opening petition. Jurisdiction is invoked pursuant to 28 U.S.C. 1254.

STATUTES INVOLVED

Bankruptcy Code — Property of the Estate

11 U.S.C. 541(d):

> Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

Internal Revenue Code —

Property of Delinquent Taxpayer

26 U.S.C. 6321:

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

STATEMENT OF THE CASE

Cross-petitioners joined the United States Internal Revenue Service as defendant in this action because the IRS had asserted a lien for unpaid taxes on the properties involved in this case. The IRS claimed the right to collect from the properties taxes owed by Alexander and Rosemary Butcher. The District Court ruled that the constructive trust interests of cross-petitioners defeated the IRS lien because, under Michigan law, "a trustee of a constructive trust holds bare legal title to the property that is subject to the trust for the benefit of the beneficiary." Opening Petition App. 79a.

The Court of Appeals reversed that ruling, holding that the constructive trust did not arise until the District Court's adjudication, after attachment of the IRS lien. Moreover, the Court of Appeals ruled that equity favored the IRS. Opening Petition App. 13a-17a.

Circuit Judge Eugene E. Siler, Jr., dissented from that ruling, on the ground that "the IRS had no better rights than did the Butcher family." Opening Petition App. 31a.

REASONS FOR GRANTING WRIT

This is a conditional cross-petition under Supreme Court Rule 12.5. Cross-petitioners are all respondents to the Petition other than the United States. Cross-petition-

ers were content to abide the decision of the Court of Appeals. If, however, this Court issues a writ of *certiorari* to the Court of Appeals, cross-petitioners pray that the writ include the issue raised by this cross-petition.

The Sixth Circuit Court of Appeals' decision on the IRS lien conflicts with authoritative decisions of other United States Courts of Appeals that have addressed the issue presented. The Court of Appeals properly affirmed the district court's finding that the Butcher defendants held the subject property in constructive trust for the cross-petitioning condominium owners. That finding was based upon the Butchers' misleading and deceptive conduct that took place beginning in 1978. Beginning in 1981, the Butchers' companies conveyed the condominiums to the cross-petitioners. In holding that the cross-petitioners' ownership interest was subject to a 1988 IRS tax lien, the Court of Appeals misapprehended the nature of a constructive trust. Under Michigan property law, a constructive trust arises upon the wrongful conduct of a party and immediately defines the wrongdoer's interest in the property. In this case, the Butchers were constructive trustees. They had no ownership interest, no equitable interest, to which the 1988 tax lien could attach. The Court of Appeals' finding that the property was subject to a constructive trust cannot be reconciled with the Court of Appeals' finding that the IRS tax lien attached to the property, as a matter of Michigan property law.

A. Under Michigan Law, A Constructive Trust Arose Upon The Wrongful Conduct of The Butchers, Immediately Stripping The Butchers' Equitable Interest In The Property.

The Court of Appeals recognized in its opinion the well-established principle that, when the federal government asserts a tax lien against a taxpayer's property, an initial inquiry must be made concerning the taxpayer's rights in the subject property. *See* Opinion, Opening Petition App 13a. This threshold question about property rights

must be determined under state law, *Aquilino* v. *United States*, 363 U.S. 509, 512, 80 S. Ct. 1277 (1960). **After the taxpayer's interest in the property is ascertained**, federal law controls whether and to what extent a tax lien may attach to that interest.

Although the Court of Appeals initially noted this two-step inquiry, it failed to adhere to it. Rather, the Court of Appeals summarily concluded that under Michigan law, a constructive trust does not arise until a judicial decision imposes such a trust. *See* Opening Petition App.14a. The Court of Appeals then engaged in a "priority of competing claims" analysis under federal law, without fully or consistently respecting the Butchers' limited interest in the property under Michigan law. Finally, the Court of Appeals engaged in weighing the "equities" between the IRS and cross-petitioners. *Id.* at 16a-17a. The equities have nothing to do with it. This is an issue of federal and state law.[1]

Michigan courts have consistently held that the events giving rise to a constructive trust cause a split in the title of the subject property, immediately altering the nature of the wrongdoer's interest in the property. The wrongdoer holds only one of two independent titles to the property, legal title, while equitable title is vested in the party wronged. *See Stephenson* v. *Golden*, 279 Mich. 710, 746, 276 N.W. 849 (1937). Based upon this division of title, Michigan courts have imposed upon the holders of property impressed with a constructive trust a duty to account for and pay over any rents or profits derived from the property prior to enforcement of the trust. *See Nichols* v. *Martin*, 277 Mich. 305, 269 N.W. 183 (1936).

---

[1] Even if equity was involved in deciding whether the IRS should be able to satisfy the Butchers' debts out of cross-petitioners' property, Circuit Judge Siler correctly observed that "I would not find that [the IRS] is more faultless than the condominium owners, who relied upon legal opinions that they had proper title." Opening Petition App. 31a. Nor does it seem equitable to pay the Butchers' taxes with the condominiums cross-petitioners bought and paid for.

The requirement to pay rents and profits derived from the property prior to judicial enforcement recognized in *Nichols* cannot be reconciled with the Court of Appeals' conclusion that a constructive trust does not arise until a judicial decision imposes such a trust. The nature of the interest in property is altered upon the wrongful conduct; the judicial enforcement of the property rights has the practical effect of reunifying legal and beneficial title, which would not be necessary had the interests not been separated prior to the court's declaration.

The Michigan Supreme Court recognized that a constructive trust alters the nature of interests in property from the very moment the property was wrongfully acquired in *Fidelity & Deposit Co.* v. *Stordahl*, 353 Mich. 354, 91 N.W.2d 533 (1958). In that case, a husband and wife purchased property together. The wife used her own honestly acquired money and the husband used money embezzled from his employer. The court held that the husband's purchase of property with embezzled funds immediately gave the husband an interest in the property as trustee for his employer. Since his interest was "distinct" from that of his wife, the two could not have acquired the property as tenants by the entireties. *Id.* at 361. *Stordahl* demonstrates that under Michigan law, a person who wrongfully acquires property obtains a different interest in the property, not ownership. *Stordahl* clearly demonstrates that conduct giving rise to a constructive trust has an immediate effect on the wrongdoer's property rights.

In its opinion, the Court of Appeals cites *Soo Sand & Gravel Co.* v. *M. Sullivan Dredging Co.*, 259 Mich. 489; 244 N.W. 138, 140 (1932), for the proposition that "a constructive trust is strictly not a trust at all, but merely a remedy administered in certain fraudulent breaches of trust." Although the court in *Soo Sand & Gravel* referred to a constructive trust as a "remedy," it did **not** conclude that a constructive trust arises only upon judicial determination under Michigan law. In fact, *Soo Sand & Gravel*

supports the cross-petitioners' contention that the events giving rise to a constructive trust immediately alter the nature of a wrongdoer's rights in the property. The property at issue in *Soo Sand & Gravel* was owned by Lapish, a shareholder of the plaintiff corporation, who failed to designate the corporation as the title holder when purchasing the land on its behalf. The court held that even though Lapish held legal title to the property, the plaintiff corporation "at all times" had the absolute right to every substantial interest in the property. *Id.* at 494. Accordingly, the suit could continue in the corporation's name even though it did not hold legal title to the subject property at the time the lawsuit was filed. The bankruptcy court in *McTevia* v. *Adamo* (In re Atlantic Mortgage Corp.), 69 B.R. 321, 330 (Bankr. E.D. Mich. 1987), relied upon *Soo Sand & Gravel* when it ruled under Michigan law that "a constructive trust arises when the events which result in the constructive trust occur."

The Court of Appeals also relied on *United States* v. *Dishman Independent Oil, Inc.*, 46 F.3d 523, 526 (6th Cir. 1995), for the proposition that the priority of a federal tax lien against competing claims is governed by federal law. The Court of Appeals engaged in a "priority of competing claims" analysis under federal law, and held that only claims that meet the federal standard of "choateness" before the federal tax lien arises have priority over the federal tax lien. According to the Court of Appeals, the cross-petitioners' claims were inchoate when the IRS tax lien was filed, and were therefore subordinate to the IRS lien. *Dishman's* holding that federal law controls questions of the priority of federal tax liens is not applicable in this case because there are no "competing liens" at issue here. *Dishman* concerned the priority of a creditor's state prejudgment attachment lien on a debtor's personal property compared to a federal tax lien that attached before judgment was entered for the creditor. Here, the condominium owners' claim was not a

competing lien claim, choate or otherwise. Rather, it was a claim of ownership, correctly resolved under Michigan law. Once it was resolved that the Butchers had no rights to the condominiums, federal law dictated that there was no "property" or "rights to property" to which an IRS lien could attach. *See Aquilino*, *supra*. Accordingly, the federal law principles of priority espoused in *Dishman* are not applicable here.

In reversing the district court, the Court of Appeals noted three cases from other circuits that considered whether a tax lien could attach to property subsequently adjudicated to be held in constructive trust. All three cases resolved the issue in favor of the constructive trust beneficiary. *See* Opening Petition App. 15a-16a (citing *FTC* v. *Crittenden*, 823 F. Supp. 699 (C.D. Cal. 1993), *aff'd*, 19 F. 3d 26 (9th Cir. 1994), *Reliance Ins. Co.* v. *Brown*, 40 B.R. 214 (W.D. Mo. 1984), *TMG II* v. *United States*, 778 F. Supp. 37 (D.D.C. 1991), *aff'd in part and rev'd in part*, 1 F.3d 36 (D.C. Cir. 1993)). The Court of Appeals found the cases were unpersuasive "because they fail to explain how a constructive trust that is judicially imposed after the filing of a federal tax lien can retroactively meet the federal standard of choateness, thus priming the lien." Opening Petition App. 16a.

The reason those cases did not address the issue of choateness was that, as in the case at hand, the inquiry is inapposite; constructive trust cases simply do not involve competing claims of lien priority. In those cases the properties allegedly subject to IRS tax liens did not belong to the delinquent taxpayers. In *Crittenden*, *supra*, the court held that a constructive trust arises at the time of the wrongful act and defeats a tax lien that arises after the wrongful act but before the court has ruled that the property is subject to constructive trust. The court refused to consider issues of priority under federal law, and the related concept of choateness, because it found that a constructive trust existed under California law, and thus the tax lien could not attach to the property.

Similarly, in *TMG II*, *supra* at 46, the IRS conceded that "tax liens do not attach to properties subject to a constructive trust because, while the taxpayer may have legal title, the constructive trust gives its beneficiary equitable title."

Moreover, a number of federal cases not mentioned in the Court of Appeals' opinion have held that an IRS tax lien does not attach to property held in constructive trust. In *United States* v. *Fontana*, 528 F. Supp. 137 (S.D.N.Y. 1981), the government argued that a constructive trust does not exist until it is imposed by a court because it is merely a remedy. The court disagreed and noted that the IRS could not seize property that did not belong to the taxpayer. *See also*, *Schwarz* v. *United States*, 191 F.2d 618 (4th Cir. 1951); *Dennis* v. *United States*, 372 F.Supp. 563, 568 n.1 (E.D. Va. 1974) ("Money held in trust, whether constructive or actual, cannot be said to 'belong' to the trustee").

In short, wrongful acts immediately alter the nature of the wrongdoer's interest in the property. Thenceforth, the property is held in constructive trust. Courts take time to adjudicate these rights but the rights exist while that necessary process proceeds. The Court of Appeals could look only to Michigan law in defining the Butchers' interests in the property. Federal principles of priority are irrelevant because there are no competing claims in this case.

B. The Holding Of The Court of Appeals *In re Omegas*, That A Constructive Trust Does Not Arise Until Judicial Declaration, Is Contradicted By The Legislative History Of § 541(d) Of The Bankruptcy Code And Has Been Rejected As Wrongly Decided By The Majority Of Federal Courts To Consider It.

The Court of Appeals relied on *In re Omegas Group*, 16 F.3d 1443 (6th Cir. 1994) by analogy, based upon its premise that "because a constructive trust, unlike an

express trust, is a remedy, it does not exist until a plaintiff obtains a judicial decision finding him to be entitled to a judgment 'impressing' defendant's property or assets with a constructive trust." Opening Petition App. 15a. The holding in *Omegas* was based upon an erroneous interpretation of 11 U.S.C. § 541(d) (Bankruptcy Code). Here, the IRS lien is based upon 26 U.S.C. § 6321 (Internal Revenue Code), which, according to the Supreme Court in *Aquilino*, *supra*, defers to state law for determination of the nature and extent of a taxpayer's property interests. Thus, the Court of Appeals was required to look to Michigan law to determine the nature of the Butchers' interest in the subject property, and *Omegas* is wholly irrelevant to that determination.

More importantly, the holding in *Omegas* not only conflicts with Michigan law, but it is at odds with the legislative history of § 541(d) of the Bankruptcy Code and has been rejected by the majority of federal courts and commentators to consider it.

1. *In Re Omegas* Conflicts With The Legislative History of § 541(d) Of The Bankruptcy Code.

In *Omegas*, the Sixth Circuit held that a constructive trust is remedial and, unless such a trust has been judicially declared before bankruptcy, it does not trump the estate's interests. *Omegas*, *supra*, at 1449. The Court stated, "[n]owhere in the Bankruptcy Code does it say, 'property held by the debtor subject to a constructive trust is excluded from the debtor's estate.' " *Id.* at 1448. In so holding, the court insisted that a debtor's property be ratably distributed among creditors under the Bankruptcy Code's scheme of priority and not by means of state law constructive trust.

However, section 541(d) of the Bankruptcy Code establishes that the Code will not ratably distribute among a debtor's creditors property that belongs to third parties. Thus, § 541(d) recognizes that property claimed by the estate may in fact be subject to superior rights,

including property held in constructive trust. Legislative history to § 541(d), which the *Omegas* court did not consider, provides that:

> "Situations occasionally arise where property ostensibly belonging to the debtor will actually not be property of the debtor, but will be held in trust for another. For example, if the debtor has incurred medical bills that were covered by insurance, and the insurance company had sent the payment of the bills to the debtor before the debtor had paid the bill for which the payment was reimbursement, *the payment would actually be held in a constructive trust for the person to whom the bill was owed.*" (emphasis added)

H.R.Rep. No. 595, 95th Cong., 1st Sess., at 368 (1977); S.Rep. No. 989, 95th Cong., 2d Sess., at 82 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5868, 6324.

Thus, Congress clearly intended that § 541(d) of the Bankruptcy Code would not encompass property a debtor holds subject to a constructive trust. This court's holding to the contrary in *Omegas* directly conflicts with Congress's intent.

2. A Number Of Federal Courts Have Rejected *Omegas* As Wrongly Decided.

Federal courts in several circuits have taken issue with the holding in *Omegas*. In *Mullins* v. *Burtch* (*In re Paul J. Paradise & Associates*), 249 B.R. 360 (D. Del. 2000), Rodman Mullins filed an adversary proceeding seeking a judicial determination of ownership of a parcel of real estate identified as Lot 33. Mullins had transferred title of Lot 33 to the debtor in exchange for a note executed in his favor by the debtor. The debtor filed a bankruptcy petition without paying Mullins, and title to Lot 33 remained in the debtor's name. The bankruptcy court held that, as a matter of law, even if an equitable trust could be imposed on Lot 33 in Mullins' favor, the property was subject to the trustee's strong arm powers under

§ 544(a)(3) and, therefore, was part of the debtor's estate. On appeal, the federal district court affirmed the result reached in the bankruptcy court, but found that it was error for the lower court to have relied on the *Omegas* proposition that constructive trusts do not arise until judicially declared, "or that, as a general rule, the policy of ratable distribution necessarily trumps state equitable trust law***". *Id.* at 371. The court further observed that "the Sixth Circuit Court of Appeals' blanket statement in *Omegas*, that constructive trusts come into existence" upon judicial declaration, was "made without citation to any case authority, runs counter to the teaching of the Third Circuit and Supreme Court law, that courts must look to state law to determine whether and when constructive trusts attach in bankruptcy law." *Id.* at 370-71.

In *Skilled Nursing Professional Services* v. *Sacred Heart Hosp. (In re Sacred Heart Hosp.)*, 175 B.R. 543 (Bankr. E.D. Pa. 1994), the court criticized *Omegas* for "seem[ing] to announce a federal rule of general applicability prohibiting a bankruptcy court from ever imposing a constructive trust under applicable state law post-petition." *Id.* at 554, n7. The court noted § 541(d)'s legislative history and noted that, under Pennsylvania law, a constructive trust arises contemporaneously with the equitable duty to convey the property to another rather than upon judicial recognition.

In *Old Republic Nat'l Title Ins. Co.* v. *Tyler (In re Dameron)*, 206 B.R. 394 (Bankr. E.D. Va. 1997), *aff'd*, 155 F.3d 718 (4th Cir. 1998), creditors brought an adversary proceeding against several debtors to recover escrowed loan funds held in the debtors' bank account, because the debtors had misappropriated the loan funds by failing to disburse the funds pursuant to the lenders' closing instructions. The court held that, under Virginia law, the debtors took the funds "impressed with constructive trusts" and the funds could, therefore, be excluded from the estate under § 541(d). The *Dameron*

court criticized *Omegas* for "cit[ing] no case authority for its initial conclusion that a constructive trust arises only upon a judicial determination***" *Id.* at 399. The *Dameron* court noted that "Professor Sherwin, whose law review article *Omegas* relied so heavily upon, asserts that the 'time of creation' of a constructive trust 'is a false issue that should not enter into the courts' analyses.' " *Id.* at 400.

In *Clark* v. *Wetherill (In re Leitner)*, 236 B.R. 420, 423 (Bankr. D. Kan. 1999), Wetherill hired Leitner to perform accounting and legal services for his company. Leitner embezzled funds from the company and used the funds to purchase a home. Wetherill later discovered the fraud and sued Leitner, claiming Leitner's fraud created a constructive trust. The court anticipated Kansas would follow the majority rule that a constructive trust arises simultaneously with "the duty to reconvey the property, not at the date of final judgment declaring the trust as *Omegas* held." *Id.* at 424.

In re Reider, 177 B.R. 412 (Bankr. D. Me. 1994), the court held that the beneficiary of a constructive trust had rights superior to those of the trustee. Addressing *Omegas'* contrary conclusion, the court stated, "*Omegas* goes too far. Properly applied, constructive trust theory does not conflict with the Code's distribution scheme. Section 541(d) establishes that the Code will not ratably distribute among a debtor's creditors property that belongs to third parties." *Id.* at 415.

Andrew Kull, reporter for the Restatement of Restitution, echoed these courts' criticisms when he wrote that "[t]he Sixth Circuit's announcement that constructive trust was 'anathema to the equities of bankruptcy' contradicted a century of bankruptcy law, including Supreme Court authority, legislative history, and the standard commentary." Restitution In Bankruptcy: Reclamation And Constructive Trust, 72 Am. Bankr. L.J. 265, 272 (1998). As for *Omegas'* holding that a constructive trust is only effective upon judicial determination, Kull

noted that the notion was "impossible to square with our basic notions of property," because "ownership is not ordinarily destroyed when property is transferred by mistake ***". *Id.* at 276. Moreover, according to Kull, "the usual precept is that bankruptcy respects state-law property rights except where they have been specifically reallocated." *Id.*

Here, the Court of Appeals' citation to and reliance upon *Omegas* in its opinion is troubling for two reasons. First, the Court of Appeals was required to look to Michigan law to determine the nature of the Butchers' interest in the subject property to determine whether a tax lien could attach to it. *Omegas'* holding on when a constructive trust arises for purposes of federal law is an inappropriate inquiry. Second, the foundation upon which *Omegas* stands is weak. Its holding conflicts with the express language of the legislative history of § 541(d) of the Bankruptcy Code, and many courts have expressly rejected it. For these reasons, this Court should overrule *Omegas* as wrongly decided.

C. The Equities In This Case Favor The Condominium Owners, Not The IRS.

The Court of Appeals further justified upholding the IRS tax lien in this case because "it would be unfair to the IRS, a party without 'fault,' to prime the IRS's choate tax lien by retroactively applying a constructive trust in favor of the plaintiffs." The Court of Appeals apparently found Lawyers Title was at "fault" for failing to discover the July 12, 1978 conveyance back to the Butchers. The Court of Appeals did not provide any citation to the record.

While a court certainly has wide flexibility in fashioning equitable remedies, the Court of Appeals' ruling penalizes the only parties to this suit truly without 'fault', the condominium owners. As Judge Siler noted in dissent, the IRS cannot claim to be an 'innocent' lienholder, because it had notice at the time it filed its lien that the

condominium owners had claimed interests in the property. First, recorded deeds from the Butchers' development companies to the condominium purchasers gave notice that the purchasers claimed title to the property. Second, simple inspection of the property would have revealed that the condominium owners were in possession.[2] Dissent, Opening Petition App. 31a Notwithstanding this notice to the IRS, under the Court of Appeals' decree, the condominium owners now must suffer the imposition of a tax lien on their property. Such a decree gives the IRS a greater interest in the property than the Butchers had. That result is contrary to the holding in *United States* v. *Rogers*, 461 U.S. 677, 103 S. Ct. 2132 (1983), that once the taxpayer's interest is defined, the government's right rises no higher than those of the taxpayer. The Court of Appeal's holding is also at odds with Michigan constructive trust law, as expressed in *Fidelity of Deposit Co.* v. *Stordahl*, *supra*. In *Stordahl*, even an innocent wife was a tenant in common, not a tenant by the entireties, because her husband's embezzlement impressed a constructive trust upon his interest in the real property they purchased together. Here, the United States' lien, even if "innocent," cannot improve the Butchers' interest. They were trustees *ab initio* as a result of their wrongdoing.

---

[2] "Open, manifest and unequivocal possession of premises constitutes constructive notice of the rights of one in such possession as effectively as compliance with the recording law." *Kastle* v. *Clemons*, 330 Mich. 28, 31, 46 N.W.2d 450, 451 (1951).

CONCLUSION

If a writ of *certiorari* is issued upon the opening petition, then this conditional cross-petition should be granted also. Should the Supreme Court entertain this case, cross-petitioners pray that the Court reverse that portion of the Court of Appeals opinion subjecting the condominium owners' property to the IRS tax lien. This Court should affirm the district court's decision in all respects. Additionally, this Court should overrule *Omegas*.

James A. Smith*
Jeffrey G. Raphelson
Bodman, Longley & Dahling LLP
34th Floor, 100 Renaissance Center
Detroit, MI 48243
(313) 259-7777
* *Counsel of Record*

February 15, 2001